BRIEF IN SUPPORT OF PETITION.

Opinions Below.

The opinion of the United States Board of Tax Appeals, written by Member C. P. Smith (R. 180-92), is reported at 40 B. T. A. 768. The opinion of the Circuit Court of Appeals is by Circuit Judges Evans and Major and District Judge Lindley (Judge Major writing) (R. 213-16) and is reported at 119 F. (2d) 959.

Statement of Jurisdiction.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925 (c. 229, § 1, 43 Stat. 938; 28 U. S. C. A. § 347), to review a decision of the United States Circuit Court of Appeals for the Seventh Circuit, entered February 26, 1941 (R. 216-17). A petition for rehearing was denied June 13, 1941 (R. 217).

Statement of the Case.

A concise statement of the case is set forth in the foregoing petition (page 3), and is not repeated here.

Specification of Errors To Be Urged.

The Circuit Court of Appeals erred:

1. In holding that exhaustible property acquired from a decedent by his estate has no basis for depreciation, and that the estate is not entitled to annual deductions from income for income tax purposes by reason of the exhaustion of such property.

2. In ignoring the applicability of Section 114 (a) of the Revenue Act of 1934 (when coupled with Section 113 (a) (5) of that Act) to exhaustible property acquired from a decedent by his estate.

ARGUMENT.

The Basis for Depreciation or Return of Capital of Exhaustible Property Acquired by a Decedent's Estate From the Decedent Is Its Value on the Date of Decedent's Death.

Respondent and the Circuit Court of Appeals have both recognized that a lessor's rights to receive rents are exhaustible assets and that where such rights have a *cost*, such cost may be written off by annual deductions over the life of the rights. The only question presented to this Court is whether or not such rights, when inherited, have a basis which is the equivalent of cost for purposes of such annual deductions. It is believed that, in holding that no such basis existed, the Circuit Court of Appeals cannot have had the pertinent provisions of the Revenue Act of 1934 in mind. These provisions are as follows:

Section 23 (l) provides in general terms for depreciation deductions. It is quoted in full in the footnote.[1]

Section 23 (n) provides:

> "(n). BASIS FOR DEPRECIATION AND DEPLETION.—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114."

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1. "Sec. 23. DEDUCTIONS FROM GROSS INCOME.
"In computing net income there shall be allowed as deductions:
* * *
"(l) DEPRECIATION.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each."

In Section 114 (a) the basis for depreciation is made the same as the basis for gain, as follows:

> "Sec. 114. BASIS FOR DEPRECIATION AND DEPLETION.
>
> "(a) Basis for depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property."

It will be noted that Section 114 (a) makes no distinction between the basis fixed in Section 113 by purchase and the basis fixed in Section 113 by death, by gift, or in any other manner.

Section 113 (b) of the Revenue Act of 1934, referred to in Section 114 (a), merely adopts the basis fixed in Section 113 (a) with certain adjustments, none of which is here applicable.[2]

Section 113 (a) (5) provides in part as follows:

> "If the property was acquired by bequest, devise or inheritance or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition. * * *"

It has never been doubted that the effect of Section 114 (a) is to make exactly the same rules for basis applicable to depreciation as are applicable to gain. This is specifically stated in Article 114-1 of respondent's Regulations 86, promulgated under the Revenue Act of 1934, as follows:

> "Art. 114-1. Basis for allowance of depreciation and depletion.—The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other disposition of such property, * * *."

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2. Section 113 (b) provides in part as follows:

"Sec. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * *

(b) ADJUSTED BASIS.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. * * *"

The complete texts of Sections 113 and 114(a) and the pertinent provision of Section 114(b) of the Revenue Act of 1934 appear in the appendix.

There is nothing in the words or purpose of the statute or regulations and nothing in any decision or ruling which in any way denies that the basis defined in Section 113 (a) (5) as the date-of-death value of property received by inheritance is appropriate for purposes of determining depreciation of such property.

The Report of the Ways and Means Committee of the House of Representatives concerning the Revenue Act of 1924 (68th Cong., 1st Sess., H. Rept. 179) discussed Section 204 (c) of the 1924 Act (which was the original statutory forerunner of Section 114 (a) quoted above) as follows (1939-1 C. B. (Part 2) 254):

> "(9) The first part of subdivision (c) of the bill, that is, the part preceding the exceptions, does not correspond to any provision of the existing law, but is the same as the interpretation placed upon the existing law by the Department. It provides that *the basis of computing depreciation and depletion shall be the same as the basis of computing gain or loss from the sale of property, and represents what is obviously the correct rule,* since the theory in setting a basis for depreciation and depletion is the same as in setting one for determining gain or loss from sale; that is, *to insure a taxpayer a return of his capital free from tax.*" (Italics supplied.)

The House Ways and Means Committee Report concerning Section 114 (a) of the 1934 Act involved in this case summarily stated substantially the same rule previously stated by the Committee under the 1924 Act (73rd Cong., 2d Sess., H. Rept. 704, 1939-1 C. B. (Part 2) 575):

> "Section 114. Basis for depreciation and depletion: Subsections (a) and (b) (1) prescribe as the general basis for computing depreciation and depletion allowances, the basis for determining gain upon the sale or other disposition of property."

That the decision of the Circuit Court of Appeals in the case at hand is in conflict with these statutory provisions

appears clearly from the following quotation from the opinion (R. 214-15):

> "The respondent admits that the cost of acquiring a leasehold is an exhaustible capital investment returnable by annual deductions spread over the term of the lease. *Boos* v. *Commissioner*, 30 B. T. A. 882. But the respondent denies that there has been any *cost* to the estate in the acquisition of these leases, and consequently there can be no loss to be recovered by amortization or depreciation.
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> "Depreciation allowances are limited to depreciable property and exclude assets not of that character. *Paducah Water Co.* v. *Commissioner*, 33 F. (2d) 559. These allowances, when permitted are deductible by the entity that has acquired the asset at some 'cost,' meaning capital expenditure, or other valuable consideration. *Weiss* v. *Wiener*, 279 U. S. 333; *Commissioner* v. *Terre Haute Elec. Co.*, 67 F. (2d) 697. • • •
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> "It is also suggested that Section 113 (a) (5) of the Revenue Act of 1934 (26 U. S. C. A. Sec. 113) will operate to furnish a cost or other basis which may be amortized by the petitioners. • • • *It is plain from a reading of the statute that what is meant is to give the asset, whatever it may be, a basis for valuation for the purpose of determining gain or loss for income tax purposes in the event of a future sale of the asset.* The statute can not be construed, even in conjunction with the valuation for estate tax purposes and the payment of that tax, to place the petitioners in the position of a purchaser of the leaseholds for a valuable consideration. Therefore, the contention of the petitioners must fail, and their other contentions must fall with it." (Italics supplied.)

It will be noted that the Court has omitted all reference to Section 114 of the Revenue Act of 1934, which is the section that makes Section 113 (a) (5) applicable to depreciation as well as to gain or loss. The refusal to permit depreciation of a basis acquired upon inheritance is contrary to the express provision of the statute.

Equally clear is the conflict between the decision of the

Circuit Court of Appeals herein and the decisions of this Court and the Courts of other Circuits.

In *Hartley* v. *Commissioner*, 72 F. (2d) 352, 353, 356, 14 A. F. T. R. 444 (C. C. A. 8th 1934), the court was concerned with the basis of inherited property, both for gain or loss and for depreciation, as shown by its following statement (72 F. (2d) at 353):

> "This point is whether in estimating property gains and losses from sales of property and depletion or depreciation of such properties the basic value is that of acquisition cost to the testator or of value at death of the testator."

The court discussed the two questions together without distinction and decided both in the following language (72 F. (2d) at 356):

> "We must conclude that the Board correctly affirmed the action of the Commissioner in taking value at time of death of Hartley as the basis for estimating gain or loss on sales, during these tax years, by the executor of property belonging to the estate. For the same general reasons, estimates of depreciation or depletion of such properties should be upon the same value basis."

Upon petition for certiorari by the executor of the Hartley estate, the United States Supreme Court unanimously affirmed the decision of the Circuit Court of Appeals in *Hartley* v. *Commissioner*, 295 U. S. 216, 79 L. Ed. 1399 (1935).

In the *Hartley* case the question was almost identical with the question here involved, except that the positions of the Commissioner and the taxpayer were reversed. In the present case the Commissioner takes the position that, since the leases were entered into by the decedent, Henry Friend, without cost, there is no *basis*, in the decedent's estate, for depreciation of the exhaustible excess values in the leases. In other words, the Commissioner apparently argues that basis for depreciation of inherited property is

determined by cost to the decedent rather than by value at the date of death. In the *Hartley* case it was the taxpayer who argued that cost to the decedent was controlling, and the Commissioner who argued for value on the date of death. This Court held specifically that for purposes of depreciation and depletion, as well as for purposes of gain or loss, the basis is the value on the date of death, and not cost to the decedent. This Court stated as follows (295 U. S. 217):

> "The Court of Appeals for the Eighth Circuit * * * affirmed a ruling of the Board of Tax Appeals * * * and held that * * * the basis for computing gain or loss on the sale of property, *and its depletion or depreciation,* for purposes of taxing income returned by the petitioner, an executor, is its value at the date of the decedent's death, rather than the cost to the decedent, or the value on March 1, 1913, if acquired before that date." (Italics supplied.)

This Court affirmed the Circuit Court of Appeals and the Board of Tax Appeals, stating at pages 217-18 and 219-20 as follows:

> "* * * Sections 202 (a), (b) and 214 (a) (8), (10) of the 1921 Act, and §204 (a), (b), (c) of the Revenue Acts of 1924 and 1926, chap. 27, 44. Stat. at L. 9 U. S. C. title 26, §935, provide that the basis for computing gain or loss on the sale of property, and depreciation and depletion, shall be its cost, or its value on March 1, 1913, if acquired before that date. None of the acts specifically provides a basis for making the computations where return is made of income received by the estate of a decedent in the course of administration. But in the case of property acquired by 'bequest, devise, or inheritance' §202 (a) (3) of the 1921 Act and §204 (a) (5) of the 1924 and 1926 Acts provide that the basis shall be the fair market value 'at the time of acquisition'.
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> "* * * The conclusion seems inescapable that the intended date of acquisition by an executor or admin-

istrator, where the estate is the taxpayer, is the date of the decedent's death. Brewster v. Gage, 280 U. S. 327, 335, 74 L. ed. 457, 461, 50 S. Ct. 115."

At the time the *Hartley* case arose there was no provision in the Revenue Acts corresponding to Section 113 (a) (5) quoted on page 8 above. In this connection, however, this Court held as follows (220-21):

> "* * * The incorporation of the regulation in §113 (a) (5) of the 1928 Act was intended to clarify, but not to change the law. See Report of House Committee on Ways and Means, No. 2, 70th Cong., 1st Sess., p. 18; Report of Senate Committee on Finance No. 960, 70th Cong., 1st Sess., p. 26; Report of Joint Committee on Internal Revenue Taxation, H. R. Doc. 139, 70th Cong., 1st Sess., pp. 17, 18."

The principle underlying the right granted to taxpayers to deduct from gross income amounts in respect of depreciation or exhaustion of property is that the gross receipts from depreciable property are not really *gains* or *profits* in their entirety. In substance the right to take the deductions in respect of exhaustible assets is designed to recognize such amounts as *returns of capital.* This was originally and has continued to be the foundation for the allowance of the deduction. As stated in the report of the Ways and Means Committee on the Revenue Act of 1924, quoted on page 9 above:

> "* * * the theory in setting a basis for depreciation * * * is, to insure a taxpayer a return of his capital free from tax."

The principle is the same, whether the amounts involved are treated as depreciation deductions or as exclusions from income. In both cases it is the intent of the statute to exclude from taxation amounts which represent a return of capital. This applies not only to property acquired for a valuable consideration but also to property acquired by inheritance.

Section 22 (b) (3) of the Revenue Act of 1934 requires

the exclusion from income of "the value of property acquired by gift, bequest, devise or inheritance."[3] The amount thus excluded is identical in the case of exhaustible property with the amount which may be written off by depreciation deductions pursuant to Sections 23 (l), 114 (a) and 113 (a) (5).

The refusal of the Circuit Court of Appeals to recognize the right of the executors herein to exclude from income amounts representing such return of capital in the case at hand is in conflict with the express decision of this Court in *Burnet* v. *Logan*, 283 U. S. 404, 413-14, 75 L. Ed. 1143, 1148 (1931). In the *Logan* case the taxpayer and the taxpayer's mother had transferred stock in one corporation to another corporation in return for certain cash and the right to receive cash payments for a limited period. Subsequently, the taxpayer's mother died and the taxpayer inherited the rights to receive the periodic payments which had been acquired by the mother. The United States Supreme Court held that the taxpayer was entitled to a return of her cost (with respect to her own rights to receive periodic payments) and of the estate tax value (with respect to her mother's similar rights) before any of the receipts in question could be taxed as income. The Supreme Court stated as follows:

> "From her mother's estate Mrs. Logan obtained the right to share in possible proceeds of a contract thereafter to pay indefinite sums. The value of this was assumed to be $277,164.50 and its transfer was so taxed. Some valuation—speculative or otherwise—was necessary in order to close the estate. It may never yield as much, it may yield more. If a sum equal to the

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3. "Sec. 22. GROSS INCOME.

* * * * *

"(b) EXCLUSIONS FROM GROSS INCOME.—The following items shall not be included in gross income and shall be exempt from taxation under this title: * * *

"(3) GIFTS, BEQUESTS, AND DEVISES.—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income)."

value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment. We think a like rule should be applied here. The statute definitely excepts bequests from receipts which go to make up taxable income. See *Burnet* v. *Whitehouse*, 283 U. S. 148, 75 L. ed. 916, 73 A. L. R. 1534, 51 S. Ct. 374."

In the case at hand the rights of the executors to receive periodic cash payments under the lease contracts (to the extent of the excess over and above the fair market value of the land) were identical in nature with the rights to periodic payments in the *Logan* case and equally finite in amount and duration. The right to receive their date-of-death value without tax is established by the *Logan* case and the denial of that right by the Circuit Court of Appeals is in conflict with that decision.

In addition, it is submitted, the decision of the Circuit Court of Appeals is in conflict with the decisions of four other Circuit Courts of Appeals on the same matter, namely, the Third, Fourth, Fifth and Eighth.

In *Dobbins* v. *Commissioner*, 31 F. (2d) 935, 936, 7 A. F. T. R. 8645, 8646 (C. C. A. 3rd 1929), the taxpayer's husband had received by bequest the right to income from a certain trust during the life of his sister. Subsequently the husband died, bequeathing to the taxpayer, his wife, the right to the income for the period after his death until his sister's death. The court held in effect that, while the property which had gone into the trust had been owned in its entirety by the first decedent and consequently the income from the trust was taxable as income to the taxpayer's husband whose right to income had not arisen until the death of the first decedent, the separation of the right to income for a specified period from the rest of the trust property had been effected prior to the death of the husband, and

consequently the property which was subject to bequest by him and which was actually bequeathed to the taxpayer was not the property from which the income was derived but rather the mere right to income itself and this was the way it had been appraised for estate tax purposes by the Commissioner. Consequently the moneys received by the taxpayer were received not as income, although they constituted income distributions from the trust, but as a return of capital of the bequest received from her husband. The court stated:

> "The income from this trust was taxable to Murrell Dobbins and was included in his tax returns, but when he died this fixed income became a part of the corpus of his estate which he could dispose of by will just as he could dispose of any other property which belonged to him. This was the then opinion of the Commissioner, and so he had it appraised. The amount of its appraised value was based upon the expectancy of the life of Mary A. Dobbins, during which payments were to be made, and an estate tax was accordingly paid thereon.
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> "The appraised value of $212,438.05, fixed for the purpose of estate taxes, was based upon the theory that this was part of the estate of Murrell Dobbins. While the fund here taxed might have been income to the estate of Murrell, it was a legacy in the hands of Emily M. Dobbins, received not from Edward T. Dobbins, or his estate, but from Murrell Dobbins, under the residuary provisions of his will, and as such it was not taxable to Emily. The estate tax, which it seems to us was rightly paid, is indefensible on any other theory. The appraisement was not mathematically correct, for it might have been increased or decreased. This depended upon the length of the life of Mary A. Dobbins. It was an estate of inheritance passing under the will of Murrell, payable in installments, and not in a lump sum, though it might have been sold as such by Emily. A legacy or bequest left by will is not taxable as income."

Several years later the Commissioner again sought to tax the same income to the legatee of the previous taxpayer who had also died, bequeathing to her children her right to the income from the trust acquired from her husband. The court again held that the amounts received by the legatee were not taxable income, in *Commissioner* v. *Dobbins*, 72 F. (2d) 984, 985, 14 A. F. T. R. 545, 546 (C. C. A. 3rd 1934), stating as follows:

> "The important thing is not to confuse income from inheritances with inheritances. The Commissioner, himself twice treated the value of the interest of Murrell in the trust as an inheritance or legacy by imposing the estate tax on that interest."

In *Rose* v. *Grant*, 39 F. (2d) 338, 8 A. F. T. R. 10494 (C. C. A. 5th 1930) the life tenant of a testamentary trust claimed a refund of income taxes based upon depreciation of certain buildings and other exhaustible portions of real estate which formed part of the corpus of the trust. The District Court held that the life tenant was entitled to deduct depreciation based upon the value of the exhaustible property on the date of the decedent's death, and this decision was affirmed by the Circuit Court of Appeals for the Fifth Circuit.

In *McCahill* v. *Helvering*, 75 F. (2d) 725, 15 A. F. T. R. 304 (C. C. A. 8th 1935) the Circuit Court of Appeals for the Eighth Circuit considered the amount of depletion deductible with respect to depletable property acquired by inheritance. As shown in Section 114 (b) (1) of the Revenue Act of 1934, quoted in the appendix hereto, the general rule for determining depletion is stated in the same terms as the general rule stated in Section 114 (a) for depreciation. Under both, the basis is the same as the basis for gain provided in Section 113. The rule was stated by the Circuit Court of Appeals at pages 726-27 as follows:

> "* * * The relevant substance of the statutes is that in the case of coal mines the taxpayer shall be

> allowed as deductions from gross income 'a reasonable allowance for depletion * * * according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations * * * of the Secretary.' And it is provided that the basis for depletion in the case of a coal mine acquired by specific devise 'shall be the fair market value of the property at the time of the death of the decedent.' "

The Circuit Court of Appeals held that depletion was allowable based upon the proven value of the depletable property as of the date of the decedent's death.

Burnet v. *Logan*, 283 U. S. 404, 75 L. Ed. 1143 (1931) was quoted and followed in *Peak* v. *Commissioner*, 80 F. (2d) 761, 17 A. F. T. R. 117 (C. C. A. 8th 1936). In that case the taxpayer received by inheritance the right to certain payments of income of a corporation pursuant to a contract entered into by the decedent. This right was valued at $700,000 as of the date of death. Actually the payments aggregated more than $700,000. It was conceded generally that $700,000 could be received free from income tax, and the only question involved was the right of the taxpayer to receive amounts in excess of $700,000 free from income tax. The Circuit Court of Appeals for the Eighth Circuit held, affirming the Board of Tax Appeals, that the date of death value of the contract rights controlled in the determination of the portion of the amounts received pursuant to the contract which constituted return of capital, and that income commenced to be realized immediately after the aggregate receipts equalled the date-of-death value.

In *Burnet* v. *Hanlon*, 51 F. (2d) 463, 465, 10 A. F. T. R. 267 (C. C. A. 4th 1931) the Fourth Circuit Court of Appeals stated as follows:

> "When the Revenue Act of 1921 was adopted, the Commissioner applied the same basis to the computation of allowances for depreciation as was applied in

> computing profits on the sale of property. A like uniform basis had previously prevailed. It was evidently the intention of Congress when the act was passed to recognize and approve this method of computation. As originally drawn, the statute made provisions for the same basis for allowance for depreciation as in cases of sale. These provisions were stricken from the bill merely because they were deemed as surplusage."

In the *Hanlon* case the question involved was the basis for depreciation of exhaustible property received by gift. This question is substantially identical with the question of the basis for depreciation of inherited property. Section 113 (a) (4) of the Revenue Act of 1934, immediately preceding Section 113 (a) (5) (applicable to inherited property) and its predecessor provisions in prior statutes provide that the basis for gain or loss of property transferred by gift prior to January 1, 1921 is the fair market value of the property at the date of acquisition, and the only provision which makes that basis applicable for depreciation is the same provision in Section 114 (a) which is shown above to be applicable to inherited property.

The authorities have consistently held that the basis for depreciation of gift property is the same as the basis for gain, namely, the fair market value on the date of gift.

Conclusion.

A diligent search has failed to disclose any decision or ruling supporting the interpretation by the United States Circuit Court of Appeals in the case at hand, and on the contrary, as noted above, that decision of the Circuit Court of Appeals is in conflict not only with the express provision of the statute but also with the decisions of this Court and of the Courts of Appeals of numerous other Circuits.

The issue is clear. The executors inherited—in addition to the fee simple interest in the land—rights to periodic

money payments having a fair market value concededly in excess of the fair market value of the land alone. This excess value of periodic payments is admittedly exhaustible and will terminate with the termination of the lease contracts under which the payments are made. The land is of course inexhaustible. This exhaustible excess value, as of the date of death, under the statute and the decisions should be receivable by the executors free from income tax, either as deductions for exhaustion or as return of capital.

The respondent concedes and so does the Circuit Court of Appeals that if cash had been paid for this exhaustible excess value, the return thereof without tax would be allowed. It is contended, however, that a difference exists between the case of persons who acquire such property rights by purchase and those who inherit them. This contention is contrary to the express language of the statute and all of the pertinent authorities.

The import of such a decision is tremendous. It extends not only to cases in the nature of annuities involving periodic contract payments, but also to other forms of exhaustible property such as buildings on inherited land. *The plain meaning of the decision of the Circuit Court of Appeals would deny the right of persons inheriting real estate to take any deduction for depreciation of buildings on that real estate.* It is submitted that the principle enunciated by the Circuit Court of Appeals is a flagrant denial of rights assured taxpayers by the plain unambiguous language of enactments by Congress and the decisions of this Court and of the Courts of Appeals of other Circuits thereunder.

It is submitted, moreover, that the denial of the right to receive such returns of capital free from tax is an extension of the meaning of income subject to taxation beyond the intent of the Sixteenth Amendment to the Constitution of

the United States as interpreted by the decisions of this Court.

The decision of the Circuit Court of Appeals is contrary to the applicable decisions of this Court and the other Circuit Courts of Appeals, as well as to the unmistakable language of the applicable statute, and it is necessary that the decision of the Circuit Court of Appeals be reviewed by this Court in order to avoid confusion resulting from conflict of decisions, as well as to avoid a patent injustice to the petitioners herein, which will continue for many years.

All of which is respectfully submitted,

A. J. Pflaum,
Harry N. Wyatt,
Counsel for Petitioners.
33 North La Salle Street,
Chicago, Illinois.

Of Counsel:
D'Ancona, Pflaum, Wyatt, Marwick & Riskind,
33 North La Salle Street,
Chicago, Illinois.